The Internal Revenue Service Needs to Be Consistent and Fair When Assessing Interest and Penalties on Employers Who Misclassify Their Employees

January 2003

Reference Number: 2003-30-042

INSPECTOR GENERAL
for TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

January 16, 2003

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Internal Revenue Service Needs to Be Consistent and Fair When Assessing Interest and Penalties on Employers Who Misclassify Their Employees (Audit # 200230018)

This report presents the results of our review of the assessment of penalties on certain employment tax returns. The overall objective of this review was to determine if the Internal Revenue Service (IRS) was achieving its goal of applying penalties in a fair and consistent manner on these returns. Specifically, we focused on employment tax returns where penalties were assessed but interest was waived.

Employment taxes, which are taxes paid by businesses on the salaries of their employees, represent a significant portion of the revenue collected by the IRS. These taxes are assessed on amounts paid to employees but are not assessed on amounts paid to workers who are not employees. Laws defining who is and who is not considered an "employee" of a business are confusing to many taxpayers. Businesses that misclassify their workers as non-employees, when they should have been classified as employees, can be liable for significant amounts of back taxes. Although Internal Revenue Code (I.R.C.) Section 6205[1] allows interest to be waived on these back taxes if certain requirements are met,[2] it is silent regarding the assessment of penalties. Generally, the Congress has given the IRS wide latitude to waive penalties on unpaid taxes, but has strictly limited the instances when the IRS could waive interest. Given

[1] I.R.C. § 6205 (2000).
[2] Interest waiving provisions apply if the error is corrected during the same period in which it was ascertained, if payment of the tax is made no later than the due date of the quarterly return in which the error was discovered, and if the taxpayer has not previously been informed of his or her tax status as an employer and knowingly underreports the employment tax liability.

these facts, it seems unreasonable that the Congress, in allowing interest to be waived on these employment tax cases, would not expect penalties to be waived as well.

In summary, we found the IRS assessed employers over $4.35 million (over a 3-year period) in penalties on employment tax accounts where interest was waived due to Section 6205 provisions. In some cases, the IRS assessed these penalties even after indicating to taxpayers that the penalties could be waived. In our opinion, it is inconsistent to charge penalties on these employment tax returns when interest is being waived. Further, even though businesses were told that interest would not be assessed on the employment taxes owed, the IRS nevertheless assessed over $2.54 million in interest on the penalties themselves that were applied to those taxes. Finally, we question whether the interest waiving provisions of the law should apply to misclassified employee returns. Employers who misclassify their workers may be provided with a tax break that was intended to address a different issue. This tax break may even increase employers' incentives to misclassify their workers.

To address these concerns, we recommended that the IRS reprogram its computer system so the computers do not automatically assess penalties on late-filed employment tax returns where Section 6205 provisions are being applied. We also recommended that the IRS issue instructions to applicable employees telling them not to assess penalties on employment tax return examinations where this Section applies. Finally, we recommended that the IRS determine whether the original intentions behind the interest waiving provisions of Section 6205 should apply to misclassified employee returns, and work with the Department of the Treasury to recommend appropriate legislative changes or changes to the pertinent regulations.

Management's Response: The IRS generally agreed with the recommendations in this report and is taking steps to implement them. Due to a proposed regulation that could result in even more penalties being assessed on employment tax returns, the IRS determined that it should implement our recommendation to review the continued applicability of Section 6205 to misclassified employees before taking any of our other recommended actions. Contingent on the results of its review, the IRS agreed to use specific computer codes to stop its computers from automatically assessing penalties on cases meeting Section 6205 criteria and update instructions to its employees. Management's complete response to the draft report is included as Appendix V.

Office of Audit Comment: As detailed in our report, we agree with the IRS regarding the importance of reviewing the continued applicability of Section 6205 with respect to misclassified employee cases. We further agree that the importance of the IRS' review is increased because of the proposed regulation to assess even more penalties. However, if no other actions are taken until the IRS' review is complete, the IRS will knowingly continue to apply the tax code inconsistently by assessing penalties while waiving interest on late-filed returns involving misclassified employees. In our opinion, the IRS should take immediate action (as described in Recommendations 1 and 2 of this report) to waive penalties on these cases, until it determines the continued applicability of Section 6205 and its related regulations. If the IRS finds that Section 6205 should not apply to misclassified employee cases, it would then be

appropriate to work with the Department of the Treasury to amend regulations or seek legislation providing for the assessment of both interest and penalties on these cases.

While we believe that immediate action on all of our recommendations is necessary for the IRS to consistently and fairly implement the tax code as currently written, we do not intend to elevate this issue to the Department of the Treasury for resolution.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Parker F. Pearson, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (410) 962-9637.

Table of Contents

The Internal Revenue Service Needs to Be Consistent and Fair When Assessing Interest and Penalties on Employers Who Misclassify Their Employees

Background

Businesses with employees are generally required to withhold income, Social Security, and Medicare taxes from their employees' wages and turn the amounts withheld over to the Federal Government. These businesses are also generally required to match the amounts they withhold from their employees for Social Security and Medicare taxes, and pay the matching amounts (called "employment taxes") to the Internal Revenue Service (IRS) quarterly.[1] Businesses are generally not required to withhold or pay employment taxes on amounts paid to workers who are not their employees.

Laws defining who is and who is not considered an "employee" of a business are confusing to many taxpayers. Often, businesses may, in good faith, treat workers as non-employees when they should be treated as employees. Later, if the businesses or the IRS discover the error, the businesses are responsible to pay all back employment taxes for the misclassified employees. These back taxes can be either self-assessed (i.e., businesses identify the errors and report the back taxes themselves) or assessed by the IRS as the result of an employment tax examination.

Normally, business and individual taxpayers are liable for interest and penalties on any taxes that are not paid by the due date of their tax returns. However, employment tax regulations under Section 6205 of the Internal Revenue Code (I.R.C.)[2] allow employers to make adjustments to returns without interest[3] "until the last day for filing the return for the quarter in which the error was ascertained." An error is defined as "ascertained" when the employer has sufficient knowledge of the error to be able to correct it.

Although the I.R.C. allows interest to be waived on these employment tax returns, it is silent regarding the assessment of penalties. We reviewed the IRS' administration of the employment tax laws as written for assessing interest and penalties on back taxes due as a result of the

[1] In Fiscal Year 2001, the IRS collected over $682 billion in employment taxes.
[2] I.R.C. § 6205 (2000).
[3] The IRS treats misclassification of employees as an adjustment that meets the requirements of Section 6205.

misclassification of employees. We also assessed how changes to employment tax laws over time may have created the necessity for the IRS to seek modification to Section 6205 or its applicable regulations.

We conducted our audit at the Ogden IRS Campus from December 2001 to August 2002 using tax return information filed nationwide. The audit was performed in accordance with *Government Auditing Standards.* Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Penalties Should Not be Assessed on Accounts Where Interest Is Being Waived

We identified 2,766 cases over a 3-year period[4] on which the IRS assessed back employment taxes, waived the interest associated with the assessments (due to Section 6205 provisions), but assessed penalties (failure to file, pay, and deposit) against the employers. In our opinion, it is inconsistent for the IRS to assess penalties related to errors made by employers in determining the employment status of their workers, when it is waiving interest related to the same error.

Treasury Regulations applicable to Section 6205 specifically allow employers to make adjustments to returns, without interest, if they pay any taxes related to those adjustments by the due date of the quarterly return on which the error was ascertained. This provision applies regardless of whether the employer or the IRS first ascertains the error. Basically, in these cases, the IRS waives the interest until the employer has sufficient knowledge of the error to be able to correct it. To waive interest because the employer did not have knowledge of the error, but to assess a penalty related to that error, is an inconsistent application of the tax law.

Historically, the Congress has given the IRS wide latitude to waive penalties on unpaid taxes but has strictly limited the instances when the IRS could waive interest. For example, the IRS has authority to abate penalties for "reasonable cause." Reasonable cause relief can be granted at the IRS'

[4] See Appendix I – Detailed Objective, Scope, and Methodology for additional information concerning the 2,766 identified cases.

discretion when the IRS determines that taxpayers exercised ordinary business care and prudence in determining their tax obligations. However, the IRS is only allowed to abate interest through statutory provisions or because of IRS errors or delays. There is no provision for abating interest at the IRS' discretion, not even for reasonable cause. Given these facts, it seems reasonable that the Congress, in allowing interest to be waived on these employment tax cases, would expect penalties to be waived as well.

As previously mentioned, a reason the IRS frequently uses to waive penalties on a tax assessment is that the taxpayer had a reasonable cause for not reporting or paying taxes. Regulations under Section 6205 waive interest on an assessment until the employer has sufficient knowledge of the misclassification to be able to correct it (i.e., the ascertainment date). The fact that the employer did not have sufficient knowledge implies reasonable cause, which would therefore suggest that the penalties should also be waived.

In addition to the problem of assessing penalties on these accounts, we identified two other problems associated with this issue. These problems are also a condition of assessing penalties on these accounts when interest is being waived.

The IRS assessed penalties even after giving businesses indications that they would not be assessed

Of the 2,766 returns on which penalties were charged but interest was not, we identified 401 returns that were worked under the IRS' SS-8 Program.[5] Employers under this program whose workers are determined to be employees receive a letter from the IRS stating:

> *"By taking the initiative to correct your account, you may be able to forego any*

[5] This IRS program aids businesses and individuals in determining the employment status of workers. For this program, workers and/or businesses fill out a Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding (Form SS-8). The IRS evaluates the facts, makes a determination concerning the status of the worker, and notifies the business and the worker of the determination. This does not constitute an employment tax examination.

> *applicable penalties in connection with this matter. If you will file the employment tax return and pay the taxes in full, we will attempt to provide relief from any penalties that may be due."*

Not only did the IRS assess penalties on these cases, but we also found evidence that at least two of the businesses specifically asked the IRS to abate the penalties as it had said it would. Both these businesses had paid the additional taxes timely, but the IRS did not abate the penalties.

Although we only identified 2 businesses that specifically asked the IRS to abate their penalties, we reviewed 115 of the 401 returns to determine how many businesses paid the tax and filed the returns by the due date of the quarter in which the error was ascertained. We found 85 (74 percent) of these 115 businesses paid and filed timely. As stated previously, it is our opinion that penalties on these cases should not have been assessed at all. Stating that the IRS would attempt to provide relief from the penalties, and then not addressing the issue, would likely frustrate taxpayers and cause additional burden.

Most returns are being charged interest on the penalty

For the 2,766 returns we identified on which the IRS had assessed back employment taxes but waived the interest related to that assessment, 2,195 (79 percent) had assessments of both the failure to file penalty and interest associated with that penalty. By law, interest is charged on the failure to file penalty from the original due date of the tax return until it is fully paid. The interest waiving provisions of Section 6205 only apply to the tax, not to interest on the penalty. Although the IRS has legal authority to assess interest on the failure to file penalty, it is once again inconsistent to assess the penalty, and accordingly, interest on the penalty.

Hypothetical example

The following is a hypothetical example to help illustrate the overall Section 6205 process. Assume that a small company started a business in October 1999 and treated its workers as independent contractors (i.e., non-employees).

After an examination of the company in March 2002, the IRS determined the workers were actually employees. The IRS would have then assessed Social Security and withholding taxes, along with a failure to file penalty because the business did not file an original return in January 2000, when the return was due.

Assume the business paid the tax assessment in full by the due date of the quarterly period (April 30, 2002) in which it became aware of the error (examination date, March 2002). The IRS would then have waived the interest charge that normally would have been computed on the tax from January 2000 (due date of the original return) until the tax was full paid (April 2002). However, it would still assess the failure to file penalty from the original due date of the return (January 2000). In addition, it would assess interest on that penalty until the penalty was paid.

Therefore, the employer would have had interest waived on the employment tax assessment because, until March 2002, he or she did not have sufficient knowledge of his or her error to file an appropriate employment tax return. However, the employer would have been assessed a failure to file penalty and charged interest on that penalty.

Why these conditions occurred and their impact

These conditions occurred for two reasons:

- Section 6205 did not provide clear guidance on whether penalties should be assessed.
- The IRS has not recognized the inconsistency of assessing penalties while waiving interest.

In reviewing the IRS' instructions and training material, we were unable to find any procedures indicating that penalties should not be assessed on these accounts when interest is being waived under Section 6205.

As a result, over a 3-year period, the IRS assessed employers over $4.35 million in penalties (failure to file, pay, and deposit) on the 2,766 employment tax assessments meeting the criteria of Section 6205. In addition, the IRS assessed over $2.54 million in interest on the failure to file penalties.

Recommendations

The Director, Office of Penalties and Interest, Small Business/Self-Employed (SB/SE) Division, should:

1. Request programming changes that would restrict the IRS' computer system from automatically assessing penalties on late-filed employment tax returns for which Section 6205 applies. This programming could be similar to the M Code[6] provisions that now restrict interest from being assessed on these types of tax returns.

Management's Response: The IRS reviewed the available tools for addressing this recommendation and determined computer programming changes were not needed. Computer codes currently available can be used to stop the automatic assessment of penalties on employment tax returns meeting Section 6205 criteria. (See Office of Audit Comment on page 9.)

2. Issue instructions not to assess penalties on employment tax examinations or adjustments where Section 6205 applies.

Management's Response: The IRS will prepare and issue guidance to the field, including an update to the Internal Revenue Manual. This update will include guidance concerning the assessment or non-assessment of any penalties based on the results of their efforts in Recommendation 3 (pages 8 and 9). (See Office of Audit Comment on page 9.)

[6] An M Code is a code entered on a tax return by IRS employees at the time of processing that causes the computer to not assess interest on the tax return.

Congressional Intent Behind Internal Revenue Code Section 6205 May No Longer be Valid in Today's Business Environment

The interest-free provisions of Section 6205 can be traced back to the Social Security Act of 1935.[7] This Act contained the following statement:

> *"If more or less than the correct amount of tax imposed by Section 804[8] is paid with respect to any wage payment, then, under regulations made under this title, proper adjustments with respect to the tax shall be made, without interest, in connection with subsequent wage payments to the same individual by the same employer."*[9]

The Committee Hearings on this Act contained the following statement by Mr. Beaman:[10]

> *"In other words, the theory of this Section is that if, as will undoubtedly happen, particularly at the start, there comes the pay day and the employer deducts the wrong amount through a mistake or misinterpretation of the law, or what not, deducts too much or too little, the theory of this paragraph is that the adjustment will be made at the next payday. We want to insert after the word 'made' the words 'without interest.' In other words, the idea is that, as to these small amounts, you do not have to bother about interest."*[11]

The intent of Section 6205 may no longer be valid for the following reasons:

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[7] Social Security Act of 1935, Pub. L. No. 74-271, 49 Stat. 620 (1935) (codified as amended in scattered sections of 42 U.S.C.).
[8] Social Security Act of 1935, 42 U.S.C § 1004 (1935) (repealed 1939) (current version codified with some differences in language at 26 U.S.C. § 3111 (2000)).
[9] Social Security Act of 1935, 42 U.S.C § 1005 (1935) (repealed 1939) (current version codified with some differences in language at 26 U.S.C. § 6205(a), 6413(a) (2000)).
[10] Mr. Beaman was Legislative Counsel in the House of Representatives and had responsibility for drafting the Bill.
[11] Social Security Act Hearings before the Committee on Finance, United States Senate, Seventy-Fourth Congress, H.R. 7260.

- The most common errors made now relate to worker status rather than mathematical computations. All of the 2,766 returns we identified involved a worker status dispute rather than a withholding error being made on the tax return. Two IRS tax employment examination specialists verified that our cases were typical of most employment tax examinations. Given this fact, the original concept that interest would not be charged because the errors would be small and made up on future returns is no longer valid.
- Employers' financial motives to misclassify workers as non-employees have increased since Section 6205 was originally enacted. Social Security rates have increased and additional employment taxes have been added, such as the Federal Unemployment Tax and Medicare. In addition, employers were not originally required to withhold federal income taxes from their employees' wages, but must do so now, creating a bookkeeping and accounting burden. Also, employees are entitled to many benefits such as health insurance, paid vacation, retirement, etc., to which non-employees are not entitled.

Because of these facts, employers who misclassify their workers may be provided with a tax break that was intended to address a different issue. This tax break may even increase employers' incentives to misclassify their workers.

Recommendation

3. The Director, Office of Penalties and Interest, SB/SE Division, should solicit input from the Office of Chief Counsel and the Director, Compliance, SB/SE Division, regarding the continued applicability of Section 6205 and its related regulations as it currently pertains to misclassified employees, and work with the Department of the Treasury to recommend appropriate legislative changes or changes to the pertinent regulations.

Management's Response: The IRS agreed to appoint a group to study the continued applicability of Section 6205 to misclassified employees along with a new proposed

regulation. This group will include representatives from the SB/SE Division's Compliance Policy and Compliance functions, the SB/SE Division's Chief Counsel, and the Large and Mid-Size Business and Tax Exempt/Government Entities Divisions. They will discuss their findings with the Department of the Treasury's Office of Tax Policy. Because of the proposed regulation, which could result in even more penalties being assessed on businesses that misclassify employees, the IRS has made this recommendation its first priority, and plans to wait until this group has made its determination before implementing Recommendations 1 and 2.

Office of Audit Comment: We agree with the IRS regarding the importance of reviewing the continued applicability of Section 6205 with respect to misclassified employee cases. We further agree that the importance of the IRS' review is increased because of the proposed regulation to assess even more penalties. However, if no other actions are taken until the IRS' review is complete, the IRS will knowingly continue to apply the tax code inconsistently by assessing penalties while waiving interest on late-filed returns involving misclassified employees. In our opinion, the IRS should take immediate action (as described in Recommendations 1 and 2 of this report) to waive penalties on these cases until the appointed group determines the continued applicability of Section 6205 and its related regulations.

If the IRS finds that Section 6205 should not apply to misclassified employee cases, it would then be appropriate to work with the Department of the Treasury to amend regulations or seek legislation providing for the assessment of both interest and penalties on these cases.

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine if the Internal Revenue Service (IRS) was achieving its goal of applying penalties in a fair and consistent manner on certain employment tax returns. To accomplish our objective, we:

I. Determined the number of possible employment tax returns on which penalties (failure to file, failure to pay, or failure to deposit) were assessed on the tax increase, but interest was not.

A. Obtained a computer extract from the IRS' Master File[1] of 401 employment tax returns containing an M Code (misclassified employee). Returns were taken over a 3-year period (Calendar Years 1998-2000).

1. Selected a statistical sample of 162 M Coded returns (universe – 401, confidence level – 90 percent, expected error rate – 50 percent, desired precision – 5 percent).

2. Reviewed 143 of the 162 sampled returns to verify that all returns contained penalties and that interest was waived under Section 6205.[2]

3. Reviewed 115 of the 143[3] returns where an ascertainment date was available to determine if the taxpayers filed the returns and paid the additional taxes timely.

B. Obtained a computer extract from the IRS' Master File of 2,365 employment tax returns containing a Transaction Code 308 (examination assessment with an interest start date). Returns were taken over a 3-year period (Calendar Years 1998-2000).

1. Selected a statistical sample of 243 Transaction Code 308 returns (universe – 2,365, confidence level – 90 percent, expected error rate – 50 percent, desired precision – 5 percent).

[1] The Master File is the IRS' main computer system containing taxpayer accounts.
[2] We ordered more returns (185) than the sample required (162) to allow for the fact that some returns would not be available. It is typical for returns to be checked out by IRS functions to be worked in various review, examination, adjustment, or other related activities. Ultimately, we were only able to obtain 143 of the 185 returns ordered.
[3] We obtained 143 returns for review. However, we were unable to determine the specific ascertainment date for 28 of these returns.

2. Reviewed 226 of the 243 sampled returns to verify that all returns contained penalties and that interest was waived under Section 6205.[4]

C. From the computer extracts, identified the number of accounts for which penalties were assessed, the average dollar amount of the penalties, the total dollar amount of the penalties, and the total dollar amount of interest assessed on the penalties. Also estimated the total dollar amount of penalties and interest assessed on those penalties over a 5-year period.

II. Determined if instructions and procedures were adequate for assessing penalties on employment tax returns.

A. Interviewed various IRS employees concerning procedures used in working and processing employment tax returns.

B. Reviewed IRS instructions, procedures, and training materials dealing with the assessment of penalties on employment tax returns.

[4] We ordered more returns (280) than the sample required (243) to allow for the fact that some returns would not be available. It is typical for returns to be checked out by IRS functions to be worked in various review, examination, adjustment, or other related activities. Ultimately, we were only able to obtain 226 of the 280 returns ordered.

Appendix II

Major Contributors to This Report

Parker F. Pearson, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs)
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Larry Madsen, Audit Manager
Kyle Bambrough, Senior Auditor
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Appendix III

Report Distribution List

Acting Commissioner N:C
Deputy Commissioner, Small Business/Self-Employed Division S
Director, Office of Penalties and Interest, Small Business/Self-Employed Division S:C:CP:RC:P
Director, Reporting Compliance, Small Business/Self-Employed Division S:C:CP:RC
Director, Taxpayer Burden Reduction, Small Business/Self-Employed Division S:T:OTBR
Chief Counsel CC
National Taxpayer Advocate TA
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Office of Management Controls N:CFO:F:M
Audit Liaison:
Commissioner, Small Business/Self-Employed Division S

Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; $11,477,047 in unwarranted penalties and interest on 4,610 taxpayer returns (see page 2).

Methodology Used to Measure the Reported Benefit:

The Information Technology staff of the Treasury Inspector General for Tax Administration provided a database containing 2,766 Employer's Quarterly Federal Tax Returns (Form 941) on which interest was waived, but penalties were assessed. These returns were identified through the use of a Master File[1] Transaction Code 308 (examination assessment with an interest start date) input to the account or through the use of a Condition Code M (interest free adjustment for Forms 941 labeled as "misclassified" employees on the returns) input to the return. The 2,766 figure was taken over a 3-year period (Calendar Years 1998-2000). The database also included the types of penalties assessed, the amount of the penalties, and the interest assessed on the penalties. The total amount of penalties, and interest on the penalties, for the 2,766 returns was $6,886,228. This averages out to 922 (2,766/3) returns and $2,295,409.33 ($6,886,228/3) in assessed penalties and interest per year. Projecting this amount over a 5-year period yields 4,610 returns and $11,477,047 in over-assessed penalties and interest.

[1] The Master File is the Internal Revenue Service's main computer system containing taxpayer accounts.

Appendix V

Management's Response to the Draft Report

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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DEC 30 2002

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Joseph G. Kehoe
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – The Internal Revenue Service Needs to Be Consistent and Fair When Assessing Interest and Penalties on Employers Who Misclassify Their Employees (Audit # 200230018)

I reviewed your draft audit report, which examined the IRS' compliance with the non-assessment of interest in accordance with Internal Revenue Code (IRC) Section 6205. I generally agree with your recommendations and we are taking steps to implement them.

Because your report does not consider proposed regulations for Section 31.6302-1 of the Employment Tax Regulations, we have prioritized the recommendations. This proposed regulation will provide that the penalty under Section 6656 applies when an employer fails to deposit taxes even if the employer did not withhold the taxes from the employee's pay. We will make Recommendation 3 our first priority to ensure that our review includes the impact of the proposed regulations.

The Office of Penalties and Interest reviewed your analysis of section 6404 (g) interest calculations performed by Master File. This analysis allows us to agree with the measurable impact that the recommended corrective actions will have on tax administration.

Our comments on the recommendations are as follows:

RECOMMENDATION 1 and 2
1. Request programming changes that would restrict the IRS' computer system from automatically assessing penalties on business returns being filed late where Section

6205 is being applied. This programming could be similar to the M Code[6] provisions that now restrict interest from being assessed on these types of business returns.

2. Issue instructions not to assess penalties on business return examinations or adjustments where Section 6205 applies.

ASSESSMENT OF CAUSE
We applied IRC Section 6205 inconsistently when we identified misclassified employees and when the employee filed subsequent employment tax returns.

CORRECTIVE ACTION
We have reviewed the available tools for addressing these recommendations and have decided we do not need a request for programming changes. Master File codes are available (D and/or R) that would accomplish this requirement. We will prepare and issue guidance to the field, including an update to the Internal Revenue Manual IRM). This update will include guidance on the imposition or non-imposition of any penalties based on the results of our efforts in Recommendation 3.

IMPLEMENTATION DATE
June 1, 2003

RESPONSIBLE OFFICIAL
Deputy Director, Compliance Policy, SB/SE

RECOMMENDATION 3
The Director, Office of Penalties and Interest, SB/SE Division, should solicit input from the Office of Chief Counsel and the Director, Compliance, SB/SE Division, regarding the continued applicability of Section 6205 and its related regulations as it currently pertains to misclassified employees, and work with the Department of the Treasury to recommend appropriate legislative changes or changes to the pertinent regulations.

ASSESSMENT OF CAUSE
The legislative history for IRC Section 6205 indicates that the purpose of the section was to allow employers to make minor corrections to employment taxes without regard to interest assessments on the under withheld tax. Over the years, the use of this section has grown to where the corrections can result in thousands of dollars in taxes.

CORRECTIVE ACTION
We will appoint a group to review IRC Section 6205 and proposed regulations for IRC Section 31.6302-1. This group will include representatives from SB/SE Compliance

[6] An M Code is a code entered on a tax return by IRS employees at the time of processing that causes the computer to not assess interest on the tax return.

Policy, and Compliance, SB/SE Chief Counsel, LMSB and TEGE. We will discuss the findings with the Department of the Treasury's, Office of Tax Policy.

IMPLEMENTATION DATE
May 1, 2003

RESPONSIBLE OFFICIAL
Deputy Director, Compliance Policy, SB/SE

MONETARY BENEFIT (S) We cannot comment on the monetary benefits contained in the report because proposed regulations for IRC Section 31.6302-1 may negate these benefits. After we have completed the actions shown in Recommendation 3, we will be in a better position to respond.

If you have any questions, please call me at (202) 622-0600, or call Joseph Brimacombe, Deputy Director, Compliance Policy, SB/SE at (202) 283-2200.